THE STRUGGLE TO CREATE A MARKET ECONOMY IN RUSSIA

by

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Abstract

Market reforms are a significant event in the history of modern Russia. Today, almost 15 years after reforms started, they are summarized as a "disaster". Answering the question of why reforms did not succeed is important for Russia, which is still experiencing a problematic transition to a market economy.

The aim of this project is to analyze what went wrong in Russia and answer the question of whether markets can be created spontaneously, without an existing institutional infrastructure. To reach this goal, the project uses a case study approach, particularly, a process study method – a method commonly used in examining public policies.

The project argues that Russia's reformers' idea about how markets function was oversimplified. Markets are not as simple as economics textbooks claim. Markets do not function in a vacuum. They are not self-forming mechanisms, but a set of institutions that are created on a gradual basis.

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There is nothing more difficult to take in hand,
more perilous to conduct,
or more uncertain in its success
than to take the lead in the introduction of a new order of things.

-Niccolo Machiavelli

1. Introduction.

The history of Russia as a modern state dates from the reforms of Peter the Great, under whom Russia began to look outward for methods to transform medieval Muscovy into a contemporary European state. His reforms, as well as those of Catherine the Great, Peter Stolypin, and Vladimir Lenin all envisioned modernizing the country and "improving" on the West, ends that Russia was never able to achieve.

From 1917 onward, the reforms set in place by Lenin and his successors determined the course of affairs in the Soviet state that replaced the Tsarist regime. However noble the efforts of the architects of the USSR may have been, it was clear that much still needed to be done to carry Russia into the future. When Mikhail Gorbachev came to power in the Soviet Union in 1985, his *perestroika* (restructuring) and *glasnost* (openness) challenged the status quo of the USSR and embarked the country on a journey to introduce the nation to a new political and economic system. For the USSR as a state, Gorbachev's reforms meant a "...reorientation of values... [and the] crumbling of Marxist-Leninist Orthodoxy" (Chernyaev, 2000, p.139). But Gorbachev's reforms did not touch the basis of socialism; they were rather an attempt to improve its realities. It is argued by Kalashnikov (2006) that the Russia we know today owes its existence to two major events – first, to the dismantling of the Soviet Union in December 1991 and second, to radical reforms, which were started in January 1992 under the leadership of President Yel'tsin and the supervision of famous representatives of Western neoclassical economic thought. Yel'tsin thus extended an invitation at the outset of economic reforms:

> We officially invite the International Monetary Fund, the World Bank, and the European Bank of Reconstruction and Development to participate in the working out of the detailed plan for cooperation and participation in economic reforms. [The International Monetary Fund provides] the proven answers of economic theory and practice (Yel'tsin, 1991 as quoted in Hough, 2001, p. 1).

Radical reforms promoted by Western advisers and eagerly accepted by Russian policy-makers included two main components – liberalization and privatization. The role of the state in the reform process had to be minimal:

> [T]he role of the State was seen not that differently from a caricature of Adam Smith's agenda: law and order, defence, primary education and basic health, some infrastructures, some help for the poor. In a deeper sense the role of the State was to 'roll back' itself: liberalization, deregulation, [and] privatization were the key words (Florio, 2002, p. 379).

An implicit assumption supported by the theoretical work of Adam Smith was that "markets are natural for humans" and that, therefore, the transition to a market system can be achieved quickly and spontaneously (Bowles, 2006). To create capitalism, Russia, according to one of the advisers, Jeffrey Sachs, had to be quick in destroying the old system (Sachs and Lipton, 1992). In return, the promise was an improved economy and better living standards.

Today, almost 15 years after reforms started, their results could be summarized in a single word—disaster. Bogomolov (2000, p. 95) writes that "during the twentieth century, no country in the world suffered in peacetime such an economic disaster as did Russia in the 1990s". What went wrong in Russia? Why did the theory and practice of radical reform, often called "shock therapy", not coincide? Answering this question is important for Russia, which is still experiencing a problematic transition to a market economy. Answering this question is also important in a broader economic sense because it will help to understand whether markets can be created spontaneously, without an existing institutional infrastructure.

Many explanations for the failure of Russian reforms exist in the academic literature. For some observers (discussed by Job, 2001), economic declines and social instability are the predictable and necessary cost of transition from a planned economy to a free market economy. For others (for example, Fedorov, 1999 & Illarionov, 1999), the Russian disaster is attributable to the fact that Russia was "spoiled" by unearned financial assistance, which was offered by the IMF without any requirements to improve the country's economic performance. For the IMF itself (cited in Florio, 2002), political obstacles were the main reason for Russia's unsuccessful reforms.

This paper will argue that none of the above explanations adequately reflects the reasons for the Russian disaster. The program of radical reforms, based on "old-fashioned macroeconomic modeling" (Stiglitz, 1999, as quoted in Florio, 2002, p. 379), could not have led to positive outcomes in the Russian reality. Markets are not as simple as economics textbooks claim. They are not self-forming mechanisms, but a set of institutions that are created on a gradual basis. To discuss and analyze the topic of the Russian path to a free market, this project will use a case study approach, particularly, a process study method, which is defined as "an examination of the logic, dynamics, and implications of a relationship between two variables" (White, 1994, p. 94). This method is commonly used in examining public policies. The project is structured as follows:

- The second section will provide a view of the political and economic aspects that were the driving forces for implementing shock therapy. It will also give an overview of shock therapy itself and its main components. Finally, it will discuss why advocates of shock therapy believed it to be the best strategy for Russia to pursue.

- The third section will discuss how shock therapy was put into practice and what its main components – liberalization and privatization – delivered to Russia, in terms of socio-economic outcomes.
- The fourth section will answer the question of why reforms in Russia have failed[1]. It will argue that reformers' ideas about how markets function were oversimplified; as well, it will attempt to show that success in reforming the economy would have emerged from a gradual strategy, which would have allowed for the incorporation of the existing institutions into the market reality and the development of new market institutions prior to the application of rapid reform measures.

2. Attempts to build a market economy in Russia – shock therapy and its advocates' expectations.

In this section, I will provide a brief overview of the political and economic circumstances that were driving forces for applying shock therapy. Firstly, I will discuss why shock therapy was chosen as a strategy for reforming Russia. Secondly, I will explain what shock therapy means in terms of reforms. Finally, I will answer the question of what shock therapy was supposed to bring to the country, what the implicit assumptions behind this strategy were.

To better understand the significance of the Russian reforms, one should consider the situation in the country in the late 1980s. As Chernyaev (2000, p. 5) puts it, the Soviet Union

[1] Failure is defined as "…the state or condition of not meeting a desirable or intended objective" (www.wikipedia.org).

in its late 1980s was "an embarrassment". The country was a great power only in a military sense because all other aspects normally associated with developed countries – science, technology, agriculture, and overall level of life – were far behind those in the West. This is not to say that the Soviet state did not have scientific achievements. But the most science-intensive industry was military. Priority was always given to the production of military goods and the heavy-industry sector, not to basic commodities. A huge military-industrial complex constituted some 80 percent of the economy (*Wilson Quarterly*, 1999, p. 99). Russia produced advanced nuclear weapons, modern submarines, and a variety of military machines and equipment but it did not succeed, for example, in the production of simple washing machines or TVs. In other words, the majority of the population did not enjoy the achievements of technological progress and scientific thought. Mikhail Gorbachev (2000) summarizes:

> In the Soviet Union, in a number of areas connected with the development and application of high technology, above all, military technology, impressive achievements were made. It is enough to mention the field of space exploration. But in most other areas – in production efficiency, the quality and quantity of goods produced, and, above all, consumer goods and technology applied to civilian use – the Soviet Union obviously lagged behind the West (p. 48).

The economy, as it operated under Soviet planning, produced goods in order to meet the requirements of that planning, not to fulfill consumer demand. This nature of socialist production created excess demand and severe scarcity, and only those who had connections would have access to goods and services. To illustrate the Soviet reality, let us refer to Mikhail Gorbachev's first speech as a Secretary General in March 1985:

> The food industry is still staffed by 60 percent manual labour, and productivity is two and a half to three times lower than in capitalist countries... Out of 11.2 million storage facilities for agricultural produce, only one-third have refrigeration and only 19

> percent have ventilation... Only 55 percent of the demand for modern equipment in the industry is satisfied. As a result, we annually lose about 30 percent of ... agriculture produce...
> Over 300 cities don't have [plumbing and sewage facilities to repair residential space]. Almost half the streets in the Russian Republic still aren't paved (quoted in Chernyaev, 2000, p.27).

Summarizing the reasons for perestroika, Gorbachev (2000, p. 56) writes: "...problems of internal development in our country were ripe, even overripe, for a solution. New approaches and types of action were needed to escape the downward spiral of crisis, to normalize life, and to make a breakthrough to qualitatively new frontiers".

2.1. "Blowing up" the Soviet economy – Yel'tsin vs. Gorbachev.

McCauley (1998) concludes that when Gorbachev started his *perestroika* (restructuring), he emphasized the following items of economic reform: gradual development of modern technologies in order to reduce manual labour; decentralization of decision-making in production by giving more freedom and power to companies' management; and active integration of the USSR into the global economy. Gorbachev had also admitted that state ownership could have been combined with co-operative and individual forms of ownership. However, as McCauley (1998) highlights, Gorbachev was not an adherent of neo-liberal economics. The purpose of his reforms, as he had constantly stated, was to revitalize the economy and to eliminate inefficiencies in manufacturing while maintaining the state-run economy of socialism. Gorbachev believed that this strategy would be able to promote economic growth and maintain social stability.

It is not in the scope of this paper to review and analyze how and why the Soviet Union had dissolved under Gorbachev's regime. The fact is that on the 25th of December, 1991, Gorbachev announced his resignation on Russian TV, and this was the day that the

Soviet Union officially ceased to exist. A few months earlier, Boris Yel'tsin had become the President of Russia. As pointed out by many (for example, Aslund, 2002; Millar, 2001; & Tompson, 2002), Yel'tsin did not have clear idea of which economic policies he would pursue. But taking into account years of confrontation between him and Gorbachev, Yel'tsin did not want to follow his predecessor's route. As Millar (2001) observes, the dominant goal for the new Russian President was political – to oust Gorbachev permanently. As a result, Yel'tsin "shopped around for an economist who would 'blow up' the Soviet [system]" (Millar, 2001, p. 5). Aslund (2002) notes that there were a few programs for reforming Russia offered to the Russian leader. According to their approaches, these programs may be divided into two major streams – gradual reform programs and radical reform programs. As summarized in *Voprosi Ekonomiki* (*Questions of Economics*, 1990), the first approach suggested that Soviet institutions can coexist with new market structures and would gradually grow into the latter. The second approach suggested maximally rapid changeover to market mechanisms and the destruction of the old Soviet institutions. The fundamental difference between these two approaches, according to Aslund (2002), lay in their views of market failure and state failure. First, gradualists gave much more credit to the planned economy and the Soviet state than radical reformers did. Second, in the gradualists' view, the Soviet state was not highly corrupt. Instead, they were more concerned about the failures of new market economy, especially in terms of possible monopoly effects. Finally, gradualists focused on demand management whereas supporters of radical reforms concentrated on the lack of supply.

Therefore, Yel'tsin had choices for the country's further development. But following his preference for "blowing up" the Soviet system, Yel'tsin chose the most radical program, prepared by Yegor Gaidar with significant help from Western advisers, particularly, that of a

Harvard professor, Jeffrey Sachs. Sachs believed that the Russian political context "argue[d] overwhelmingly for a very rapid, straightforward, and sharp program of economic reform" (Lipton and Sachs, 1990, p. 87). Presenting his program, Gaidar called himself and his colleagues "kamikaze pilots" (quoted in Millar, 2001, p. 5).

In October 1991, Yel'tsin introduced a program of "huge economic break-throughs" at the Fifth Meeting of People's Deputies of the Russian Federation. He started his speech with a statement that the "period of taking little steps is over" and it was time to take "big serious steps", which according to Yel'tsin, intended the destruction of the planned economy and the creation of a capitalist market (cited and quoted in Kalashnikov et al., 2006, p. 3). Kalashnikov et al. (2006) point out that to be able to conduct reforms quickly, Yel'tsin requested and received additional personal special powers from the Congress. For example, the Russian President could apply radical measures based on presidential decrees, without legitimizing them through the Congress. Moreover, he could appoint government officials without any parliamentary oversight as well. Yel'tsin concluded that after adopting shock therapy Russia would be able to create fundamental market mechanisms within two-three months.

2.2. What was the nature of shock therapy and what promise did it hold for Russia?

As Murrell (1993) summarizes, the nature of shock therapy in Russia may be explained as rapid transformation. Russian radical reforms consisted of two main components: marketization and privatization. Ryazanov (1998, p. 480) lists the main elements of Gaidar's program, which was a direct reflection of how the IMF and the World Bank had seen the transition to a market economy. These items were:

- Liberalization of prices and removal of central planning;
- Ensuring macroeconomic stability by adoption of anti-inflationary fiscal and monetary policies;
- Privatization;
- Liberalization of trade and lowering of tariffs.

For a country with a long history of a planned economy, these changes were to become profound. Presenting the Program at the Fifth Meeting of People's Deputies, Yel'tsin stated that Russians would meet some hardships at the beginning of the program of reforms, but that they would not last longer than six months. After that, the country would experience "liquidation of goods shortages, fast integration into the global economy, billion of dollars of investments, and, by the end of 1992 - the increase of the social welfare and overall level of life" (quoted in Sokolin, 2004, p. 53). Through the prism of time, such a perspective looks overly optimistic but Yel'tsin supposedly believed it, especially taking into account that he was assured by the Western advisers that "[people] have to realize that, in a market economy, they would still be better off than they were under the old regime" (Adams and Brock, 1993, p. 12). Jeffrey Sachs was even more optimistic and suggested that for Russia, "enormous scope exists for increases in average living standards within a few years" (quoted in Murrell, 1993, p. 4). Murrell (1993) suggests that Western advisers had truly believed in these optimistic statements: "[t]his strategy could hardly be advocated if it was thought that the immediate economic results would be disastrous" (p. 4).

As Kalashnikov (2006) notes, the majority of Russians supported Yel'tsin at that time. People remembered the firm statements he made in 1987-1990 about the necessity of democracy. Yel'tsin's actions against Gorbachev in 1990-1991 had also received significant public support because people's perception of Gorbachev by that time was of a conservative who slowed down the country's development. Finally, Yel'tsin's struggle against the August coup in 1991 created about him the halo of a fighter for a free, independent, and democratic Russia. People believed that the proposed reforms were also in the interest of the entire population. Moreover, almost every Russian remembers an all-out offensive on the part of the mass media, pointing up the "horrors" of socialism and "delights" of Western European and American standards of living.

As a result, according to polls conducted in the fall of 1991, 47 percent of respondents answered that they supported the reforms and that they were ready to experience "temporarily"[2] unemployment, price increases, and the decline of overall quality of life. Only 17.8 percent of respondents answered that they were firmly against the reforms (www.cir.ru). These results show that Russians were tired of shortages, of demagoguery, of *perestroika*, and that they were willing to put their trust in the new powers in the hope of a better life. Gorbachev (2001) writes:

> Moods of disillusionment and disappointment, loss of faith in perestroika, dissatisfaction with the worsening material situation – all these forces began to rise among the people... and populist demagogues took advantage of this, promising to correct matters in the course of one year, which was sheer balderdash. But people wanted a quick change for the better (p. 62).

Kalashnikov (2006) points out that proponents[3] of the gradual approach to Russian development had criticized shock therapy. They warned that in the reality of a highly monopolized economy, liberalization of prices would lead to bankruptcy for many companies, a decrease in production, and mass unemployment. Gradualists also stated that a straight

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[2] As was promised by the President and the Government.

[3] For example, the following Russian economists: academic Abalkin, professors Bogomolov, Shatalin, and Makarov.

monetarist model had never been applied in developed countries. The role of the state was also quite high, and it increased during crises. The opponents of shock therapy also criticized rapid privatization, which would certainly result in great unfairness. For example, professor Bogomolov (2000) recalls that a group of "moderate" economists initiated a meeting with Gaidar in late 1991 in order to warn him and his team against "liberal extremes". Bogomolov personally drew attention to cultural aspects, which were totally neglected by the adherents of shock therapy. But, as Bogomolov (2000) puts it, "[our] warnings only deserved a condescending look from young Yegor Gaidar". In early January 1992, Bogomolov gave an interview to the German *"Spiegel"* where he stated: "[we] all wait for a miracle but it will never happen. This radical reform is the biggest experiment over our long-suffering people" (quoted in Bogomolov, 2000). Bogomolov (2000) notes that when this interview was published, Boris Yel'tsin felt "insulted" and pointed out on TV that the reforms were not an experiment but well-considered steps based on economic knowledge and international experience. On the basis of the blind trust of the majority of the population, Yel'tsin was able to simply ignore all critiques of the reforms, and questions about the validity of shock therapy were turned aside.

2.3. Why shock therapy - implicit assumptions behind the strategy.

Let us now look at why Western advisers and the Russian President and government officials believed in this strategy? For Russian officials, the answer lies in a pragmatic area – money and politics. Sokolin (2004) lists the main driving forces for the Russian government to choose shock therapy:

- Shock therapy was the main strategy of market reforms advocated by the IMF and the World Bank. Therefore, choosing shock therapy gave Russia a chance to receive loans from the IMF;[4]
- In the reality of the failure of socialism, shock therapy was in accordance with the economic and geopolitical interests of member-countries of the OECD;
- Shock therapy was convenient for the ideology of the new Russian political elite, which posited the swift destruction of communism as the most important task;
- Shock therapy was an important political instrument in the power struggles at the end of 1991 – it was a tool for resistance to Gorbachev's strategies from Yel'tsin.

Why had Western advisers not seen any other alternatives? According to Brown (1994), there are two main reasons for this: first, shock therapy is easy to implement because it can be applied in any country regardless of local circumstances and culture; and second, few orthodox economists are aware of alternatives to shock therapy. As one of the advisers puts it during debate with the prime minister of one of the post-socialist countries: "…[T]he principles of physics apply to all nations; by the same token, the basic principles of economics are applicable in all nations" (quoted in Adams and Brock, 1993, p. 5). This reasoning is rooting in textbooks of neoclassical economics as far back as to Adam Smith himself, who believed that "markets are natural for humans".

[4] For example, Kalashnikov (2006) notes that the IMF offered Russia 25 billion of the US dollars, which, according to the author, the country never received.

2.3.1. Market as a natural entity.

As Bowles (2006) sums up, "[t]he act of market exchange was, for Smith, 'natural' in the sense that it was based upon a propensity which was found in all humans and, more strongly, only in humans". In other words, market exchange is common to all people. This was why, for reformers, "history, society, and the economics of present institutions [were] all minor issues" (Murrell, 1993, p. 3). Implicit to shock therapy advocates was the assumption that transitions to the market can be achieved quickly, and the capitalist market will develop "spontaneously" accomplishing all necessary institutional changes.

> ...[T]he Gaidar program was said to contain all the essential elements necessary for rapid transition to the market. Establishment of a market economy is seen as mostly involving destruction. Where institutional construction is needed, shock therapists assume that technocratic solutions are fairly easy to implement, even if an environment in which 'all the vehicles of macroeconomic policy must be constructed more or less anew, reconstituting the Central Bank and the Ministry of Finance, as well as payment mechanisms and tax collection systems'. Thus, despite the fact that 'the monetary problems in Russia are perhaps the most complex in world history, the issues of greatest importance can be solved within half a year' (Murrell, 1993, p. 5).

Murrell (1993) suggests that this optimism about institutional construction was sincere because the large scale of a radical program required the implementation of a long, interdependent sequence of measures – for example, fiscal and monetary austerity; a convertible currency; deregulation of prices; demonopolization of the state sector, etc. Further developing ideas of the 'natural' character of markets, a group of Western advisers led by Jeffrey Sachs appealed to Adam Smith's metaphor of the 'invisible hand', which would regulate everything and lead to order and "socially desirable outcomes". Criticizing (an anonymous) Prime Minister for his doubts about free market self-coordination, a Western adviser notes:

> [Y]ou haven't grasped the fundamental principle according to which markets coordinate the decisions of free individuals – the process Adam Smith called the invisible hand... Regardless of how it may sound to you, it is essential to the functioning of the free market. The heart of the market system's capacity to coordinate individual decision-making is the profit motive, acting through the forces of supply and demand... It is one of the most powerful, durable, and dependable human motives... It was Adam Smith who demonstrated compellingly how the alchemy of the market system transforms crass self-interest into social service (quoted in Adams and Brocks, 1993, pp. 23-24).

Advisers insisted that government should minimize its interventions as the markets would determine both what was to be done and how to do it: "The government must limit its activity in the economic sphere to the maximum extent possible and let the market, money, and entrepreneurs work" (quoted in Reddaway and Glinski, 2001, p. 247). An ironic comment of one of the post-socialist countries' Prime-Minister was: "Your free market is a wondrous thing. It even speaks" (quoted in Adams and Brock, 1993, p. 25).

Advocates of shock therapy argued not only for fast implementation of the reforms but also for their broad front. This proposition also derived from a vision of how markets work. Millar (2001, p. 6) summarizes that the market economy has been viewed as a "set of *2n* simultaneous supply-and-demand equations" for all the goods and services available in the economy. Millar (2001) continues that every quantity and price in the system depends upon all other quantities and prices; that is, everything depends on everything else. Therefore, according to shock therapy proponents, partial measures would fail because the institutions and habits of the old planned economy would resist change. To avoid this, changes would need to be applied everywhere.

2.3.2. Private property as a necessary supportive element to markets

Another assumption behind shock therapy was in regard to rapid and vast privatization. This assumption, derived from Adam Smith, "this is mine, that yours", implies that private property supports the market system, and that "this has proven to be the most effective way of raising general living standards" (Bowles, 2006). Reflecting this assumption, Russian neo-liberal Yavlinsky wrote in 1991:

> In economics, the core value of freedom is exercised in *a market economy* based on private ownership in which market forces of supply and demand answer the question of who produces what for whom... Ownership means the freedom to use and dispose of property as an individual chooses. Basic laws of economics tolerate no equivocation on this point, none whatsoever (quoted in Cohen et al., 1998, p. 4).

Therefore, comprehensive privatization became a major stage of Russian reforms. Jeffrey Sachs insisted that "massive and rapid privatization" had to occur "quickly and on a vast scale". Otherwise, according to him, time would work against the reforms, and economic gains would not be achieved. Andreff (1999) points out that advisers believed that the first and main objective of privatization was to create a class of effective owners who would bring about an increase of economic efficiency in macroeconomic growth, microeconomic performance, and the attraction of foreign capital.

In summary, the Russian government, supported by international monetary institutions and western economists, chose the most revolutionary and comprehensive strategy to pursue economic reforms and destroy the old communist system – the strategy of shock therapy. This strategy was expected to create the capitalist market, which was viewed as a laissez-faire economy with a secure system of property rights. This market was to bring positive changes to all aspects of the country's life. Market institutions were viewed as easy to implement and develop. Any attempts to warn against such complex and fast measures had been ignored.

> If we rephrase Smith'[s] [the butcher, the brewer, and the baker] into modern Russian reality, we may ask whether, by undertaking sweeping deregulation and a massive scaling down of the state, the Russian reformers were right in assuming that 'the banker, the gangster, and the corrupt bureaucrat' by acting in *their* narrow self-interest would bring about an optimal and collectively rational outcome (Hedlund, 2001, p. 213).

In other words, what kind of shock therapy was delivered in reality? Were its outcomes socially desirable?

3. What Did Shock Therapy Deliver?

To answer the questions outlined in the end of the last section I will analyze the main components of the shock therapy. These components are: first, liberalization and financial stabilization and second, privatization. To conclude the chapter, I will overview immediate results of the shock therapy in terms of socio-economic outcomes. Particularly, I will discuss tax evasion, racket, and the overall decline of Russia's performance. On the 31st of December 1991, during his New Year wishes speech, Boris Yel'tsin announced an official start of the "big-bang". He declared: "We all will have hard times but this will only last for six to eight months. We, Russians, need patience during this period, and by the end of 1992 all people will live better" (quoted in Zhuravlev, 1995, p. 20). In 1992, a vast number of measures were applied to liberalize the economy. Liberalization was followed by rapid privatization of nearly all sectors of the Russian economy. Despite the bright promises, shock therapy not only did not improve "average standards of living" but worsened all aspects of Russian life, both at the macro- and micro level.

3.1. Liberalization and Financial Stabilization and Their Immediate Outcomes.

In January 1992, the Russian government moved rapidly on all fronts. The measures, included the freeing of prices, the complete liberalization of trade, a thorough change in the tax system, the closing of the budgetary deficit, and a tightening of monetary policy (Aslund 2002; Kalashnikov 2006; & Murrell 1993). The whole philosophy of shock therapy was metaphorically compared by Yegor Gaidar with "put[ting] all... eggs in one basket":

> So it was a dilemma for us: to reconstruct the old tax system, or to combine price liberalization with a value-added tax of 28 percent. This second answer was very dangerous, but that was probably the only possible moment when we could adopt it. We decided to put all our eggs in one basket... (quoted in Murrell, 1993, p. 35).

Applying liberalization of prices, the government expected an approximate increase of prices by around three times. Concurrently with this measure, the state applied an increase of wages, pensions, and stipends by 70 percent, in order to protect the population. In reality, by April 1992, prices increased by six to seven times and by the middle of 1992, by ten to twelve times (Sokolin, 2004). Therefore, a 70 percent increase in income did not save Russians from falling into poverty. In September – October 1992, prices were rising by five percent a week. By the end of 1992, prices had risen by 100-150 times whereas average wages had only increased by 10-15 times (Mau, 1995, p. 32). The situation had worsened with a new problem that Russians had never faced before – delays in payments of wages, pensions, and social assistance. The government promised the eradication of shortages, and this was achieved – goods, mostly imported, appeared on shelves. But solvent demand decreased significantly. A shortage of goods had changed into a shortage of money. People's savings were also severely depreciated. The government had not developed any mechanisms to index savings.

Zinoviev (1996) points out that the shortage of money created a new phenomenon in the Russian production sphere – a crisis of mutual non-payments between Russian enterprises. By June 1, 1992, the amount of mutual debts constituted around two billion Russian rubles. As a result, companies were at the edge of complete financial collapse because they did not get payments for their goods and services. According to Murrell (1993, p. 39), "the interenterprise debt crisis was threatening the entire industrial system". The government saw a solution in issuing loans for major state companies on preferential terms by the Central Bank. But this only led to further inflation. Instead of closing the budget deficit, the government caused its increase, and tried to cover it with excessive international borrowing.

Another outcome of hyperinflation was widespread barter, which became the main form of payment between Russian companies. Polterovich (1991) notes that in countries with advanced banking systems, the share of barter is low even in the reality of inflation. But the Russia of 1992 was a country with no banking system at all. For example, money transfers within Moscow could take up to two weeks (Polterovich, 1991). Outside of the Russian capital, transfers could take as long as two-three months (Yavlinsky, 2005). It was easier for owners to carry bags of cash by plane than to transfer money through bank accounts, and by some accounts safer.

According to Oleinnik (2004), another driving force for developing barter lay in the specifics of Soviet enterprises. Soviet companies did not have alternatives in choosing suppliers and consumers. After the dismantling of the directive planning system, those companies that were in the middle of the production chain, became "hostages" of those who were close to consumers because the latter could offer a price lower than cost to the former. Therefore, barter looked like the only option for limiting opportunism of buyers and keeping production ties alive.

The trap of barter in Russia was that even when inflation had decreased significantly, and monetary exchange technology had improved, barter practices were not dropped. According to some estimates, in 1997, between 50 and 80 percent of all exchanges among the producer companies were barter based (Polterovich, 1991, p. 113). Polterovich (1991) summarizes the reasons for such resistance on the part of companies to end barter. First, breaking out of the barter system meant severing long-established connections and looking for new partners. Second, during the time of barter, a new class of businessmen – barter intermediaries – was created. This group feared losing their income if barter was eliminated, and, consequently, was a significant pressure group for the continuation of barter.

Other shock measures had also not achieved their planned goals. Liberalization of imports caused a huge flow of low-quality imported food products into Russia. The Russian agricultural sector was not able to compete with cheap imported products. As Schwarz et al. (2002) summarize, a few factors contributed to this: first, the removal of government subsidies in agriculture; second, the decrease of real income and, as a consequence, the decrease in demand for some expensive agricultural products such as meat; third, the falling of effective labour input[5]. Also, as Murrell (1993) notes, changes in foreign trade arrangements had drastically eroded a significant source of revenue. On the other side, as Zhuravlev (1995) highlights, liberalization of trade brought an opportunity for powerful individuals from foreign trade departments to fulfill primary accumulation through speculative trading. The worst outcome of such speculative trading, according to Zhuravlev (1995) was that a vast amount of money was accumulated privately, was never taxed, and was sent to personal accounts in major Western banks. Murrell (1993) also notes that the new

[5] In Soviet times, students and workers were sent to villages in the fall to help with the harvest. It was a source of cheap labour – the "helpers" were not paid, villages only provided accommodation and food for them.

value-added tax yielded only 50 percent of the sum owed in the first quarter of 1992. At the same time, the government had established the goal of closing the budgetary deficit. Consequently, the government had to apply, as Murrell (1993) puts it, "draconian cuts in spending": all major state programs were closed; financing of the army decreased significantly; state spending in the defense sphere was also cut, which led to bankruptcy of many of the most science-intensive enterprises in Russia. As a result, there was a significant brain drain of many scientists from Russia at that time.

It should be pointed out that President Yel'tsin did not completely ignore the negative results of first stage of reforms. For example, Kalashnikov (2006) shows that realizing the dangers of capital flight, Yel'tsin ordered the Central Bank and the State Customs Committee to monitor export operations. The results of monitoring were shocking – in 1994, there were 8,000 incidents of export revenue thefts. In 1995, the amount of export contracts was 73 billion US dollars whereas Russia only received 51 billion. According to experts, Russia was losing 40 billion US dollars a year through capital flight (cited in Kalashnikov, 2006, p. 20). But, as Kalashnikov (2006) argues, Yel'tsin could not realistically have done anything because it meant a war against the new economic elite of Russia, which supported him during his last years.

Assessing the immediate results of shock therapy, Murrell (1993, p. 40) writes: "Judging this approach on its own terms, as a politico-economic gambit aimed at producing a particular sequence of related policy and political changes, the result was failure". The dramatic outcomes of the reforms created distrust among Russians towards their government. Top managers of leading Russian companies also expressed their concerns about further reforms. According to Zhuravlev (1995), their concerns became especially profound after the Russian government sent the IMF a memorandum about the planned liberalization of prices of energy supplies. The political situation in the country became tense. The government had to realize that the applied shock measures did not lead to the proposed results. By the end of 1992, the government decided to move to implement another step in the reforms - privatization.

3.2. Privatization.

As the main arguments for privatization, the government used the ideas of creating effective owners, improving companies' performance, attracting external investors, and, in the end, promoting Russia's economic growth. It was stated that "privatization was not a goal itself, but a means of accomplishing a larger goal of economic development and stability" (Boycko and Schleifer, 1995, p. 75). The questions concerned the types of privatization and its speed. Sokolin (2004) points out that, for Russian reformers, the answer to the second question was obvious – privatization should be rapid, as it would lead to capitalizing of the economy and would not leave any way for reverse socialist transformation. Privatization in Russia had two major stages: a mass voucher privatization in the period between 1992 and 1994 and a cash privatization between 1994 and 1997. The scale of Russian privatization was unprecedented in modern history. As Kaufmann (1997, p. 419) observes, 6000 enterprises became private throughout the world in 1980s. At the same time, about 40,000 large-scale enterprises and 75,000 small enterprises were privatized in Russia during the first half of 1990s.

3.2.1. Mass Voucher Privatization.

Mass voucher privatization in Russia began in October 1992 when the State Committee for Property Management – Goskomimushestvo (GKI) - created voucher investment funds by assessing state property at 150 billion rubles (in 1991 prices) and dividing this number by the population of Russia (150 million people). As a result, every Russian citizen received a share of private property worth 10,000 rubles (Kim and Yelkina, 2003). The vouchers were distributed for free because, according to reformers, Russian citizens had no cash to buy shares (Ellerman, 2003). The owners of the vouchers could sell and buy them at privatization auctions. Anyone - "a rich person, a new business started by a smart entrepreneur, a Mafia front organization, a foreign company" – could buy vouchers and come to a voucher auction (Blasi et al., 1997).

The two key arguments for voucher privatization were: first, the creation of middle-class owners and second, the creation of a group of powerful outsiders who would be interested in investing in newly privatized enterprises (Hough, 2001). The first argument pursued the idea of equity for everyone - everyone would gain from voucher privatization and would become a share owing capitalist; put in other words, employees would become owners. This would give "insiders" who worked for those businesses the incentive to acquire majority ownership of them. President Yel'tsin declared, "[w]e need millions of owners rather than a handful of millionaires" (quoted in Hough, 2001, p. 77). In political perspective, that meant people who suddenly became owners-for-free would support state policy. The second argument implied that the vouchers would flow to people with financial skills and resources, which would create competition between insiders and outsiders for control of the large enterprises and would lead to their restructuring (Hough, 2001).

In the reality of hyperinflation, people were trying to sell vouchers off as soon as possible. In 1991, a person could have bought a car for 10,000 rubles but in October 1992 it was only equal to "five bottles of vodka" (Kalashnikov, 2006, p. 11). By spring 1993, when the majority of population received vouchers, 10,000 rubles was the equivalent of 30 rubles in 1991 prices. As Kalashnikov (2006) observes those people who accumulated capital during liberalization and who had connections were buying up vouchers. Other people, in the hope of receiving dividends, used their single vouchers as investments in newly created vouchers funds. But later many of these funds simply disappeared.

According to Kalashnikov (2006), during voucher privatization, mostly small and medium-size trade and service companies became private. Only 600 out of 5,000 large companies were privatized at that time. By the middle of 1993, a few giant-size companies were sold for vouchers. For example, a machine-building giant "Uralmash" with about 100,000 employees was sold for vouchers equivalent to two million US dollars, which was equal to the cost of a medium size bakery in the US (Kalashnikov, 2006, p.11). The legality of many procedures was questioned. According to the Ministry of Foreign Affairs, there were 27,000 illegal actions during privatization in 1993 (cited in Audit Chamber, 2003).

By July 1994 (the official end of mass voucher privatization), and as a result of mass privatization, 41 percent of 240,000 Russian enterprises were privatized and more than 20,000 joint-stock companies were created out of medium and large state enterprises. By the end of 1994, Russia had about 40 million shareholders of the newly established joint stock companies or the voucher investments funds (Kim and Yelkina, 2003).

3.2.2. Cash Privatization

After the completion of mass privatization in July 1994, Russia started its new stage – cash privatization, which meant selling enterprises for cash. President Yel'tsin signed a Decree called "Basic Guidelines of the State Program of Privatization of the State and Municipal Enterprises in the Russian Federation" (Kim and Yelkina, 2003). The official goal of this stage was to increase investment in enterprises with their further restructuring, but the real goal of the state was to raise revenues to finance massive federal budget deficits (Blasi et al., 1997; Cohen et al., 1998; &Hough, 2001).

During this stage of privatization the Russian state put up for sale the most economically important companies including those that encompassed natural resources, metallurgy, telecommunications, high technology, and the food industry sectors. Soon after the process started, the government realized that its expectations to eliminate the budgetary deficit by selling state companies were utopian. The total revenue realized through privatization was lower than planned (Blasi et al., 1997). The revenue from cash privatization constituted one billion rubles, which was only 50 percent of what much smaller Hungary received during its privatization (Kalashnikov, 2006, p.21). Many experts (Blasi et al., 1997; Hough, 2001; Kalashnikov, 2006; Kim and Yelkina, 2003; & Walsh, 2002) point out that the main characteristic of cash privatization was the struggle for absolute control over the privatized companies.

Cash privatization created a new type of owners later known as oligarchs. These new owners accumulated important companies and whole fields in their hands. Very often enterprises were sold for very low prices. For example, a Likhachev car factory in Moscow was sold for four million US dollars whereas the real value of its assets was around one billion dollars (Kalashnikov, 2006, p. 21). Walsh (2002) observes:

> [S]ometimes the prices were competitive; at other times they were laughably low. The worst case came when the government, strapped for cash, accepted a proposal from a consortium of wealthy businessmen ["Red Directors"], the men who would later be known as oligarchs. They offered to "manage" the poorly run state utilities and natural resources companies in exchange for a "loan" to the government. These loans gave half a dozen men shareholders control over companies such as Gazprom, which owns 30 per cent of the world's natural gas, and the equally wealthy oil giants Yukos and Lukoil... (p. 25).

The attitude of Russians towards privatization changed from the time it started to the time it ended. Debardeleben (1999) demonstrates that in the 1995-1996 survey only 29 percent of respondents supported the idea of privatization, whereas 45 percent of those questioned people considered the idea of privatization to be incorrect. The rest of the respondents answered that it was hard to make a conclusion about privatization. Also, 76 percent of the respondents identified privatization as a tool to allow the elite to retain control of property. These results contrast with 1992 survey, when "an overwhelming majority of ... respondents ...supported the *idea* of privatization" (p. 449).

By the end of the second stage of Russian privatization, the greatest portion of state resources had been sold. What were the socio-economic outcomes of radical reforms?

3.3. Socio-economic Outcomes of the Shock Therapy.

Analyzing the results of Russian radical reforms, one may observe that their main goals -improving the performance of enterprises, stimulating the country's economic growth, and improving the quality of life -were not achieved. By the beginning of 2000, the majority of companies were controlled by a few oligarchs. By the end of 1990s, the level of production in Russia constituted only 47.5 percent of its level in 1989. Foodstuffs production decreased by 51 percent and non-foodstuffs production decreased by 82.3 percent (Sokolin, 2004). Decreases in metal production, machine-building, the chemical industry, and forestry were 44, 64, 57, and 63 percent respectively. By 1997, in its production of electrical, metallurgical, and weaving machines, Russia stepped back to the levels of 1928, 1932, and 1928 respectively. The country had also experienced evasion of taxes, development of shadow racket economy, and there was an overall decline in socio-economic performance.

3.3.1. Tax Evasion.

At the time of reform, the Russian tax-collecting system was at a rudimentary stage, enforcement machinery was very weak, and even the tax police was not formed until 1997 (Polterovich, 1991; Schwartz et al., 2002; & Yavlinsky, 2005). At the same time, tax rates in Russia in the early 1990s were very high.[6] Therefore, tax evasion looked very attractive for many economic agents. Schwartz et al. (2002) point out that Russian accounting practices easily allowed companies to hide their true profitability from outsiders, which made it easy to avoid high tax rates on profits. Polterovich (1991) states that nonpayment of taxes was morally justified in Russian society. The chances of being caught were minimal due to the underdevelopment of an enforcement system and a number of contradictions in tax bylaws[7]. Moreover, the practice of nonpayment was so widespread that businesses did not expect real damage from being caught.

This mass tax evasion lead to a number of specific service systems being created: tax mediators, creators of one-day-firms, and designers of new tax evasion schemes. Almost everybody who was a university student in an economics department in the early 1990s can recall at least one term paper titled something like "Optimization of Tax Payments in Modern Reality"[8]. Similar to the situation with barter, by the time legal institutions in the tax area had started to develop, false accounting and reporting practices became widespread all over the country[9]. Polterovich (1991) writes that quitting the shadow economy was associated with high costs, and not many firms were willing to experience it.

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[6] For example, total taxes companies had to pay in the middle of 1990s were up to 90% of their net taxable income (cited in Schwartz et al, 2002, p.16).

[7] As shown in Table 2, a first real Tax Code was issued only in January 1999!

[8] The word "optimization" was usually used as a softer version of "evasion".

[9] It is still common in Russia, when potential employers are looking for accountants who are able to conduct a so-called "double-standard" accounting – to make one set of books for the company and another set for revenue services.

3.3.2. Racket as an Alternative to the State Legal System.

The absence of appropriate laws and regulations, created a situation where in order to ensure contract enforcement or to clinch a deal, businesses had to rely on the so-called "alternative judicial system", or racket. Fish (1998) writes that what is called a racket economy may also be addressed as a "criminalized" or "mafiaized" economy. Volkov (1999, p. 741) defines racket as "enforcement partnership".

> Enforcement partnership is a business function of an organized group or enterprise deriving from the skillful use of actual or potential force on a commercial basis, employed to maintain certain institutional conditions of business activities, such as security, contract enforcement, dispute settlement, and transaction insurance.

Describing the Russian racket phenomenon, Fish (1998, p. 86) writes:

> The racket economy differs from the Soviet-era command economy insofar as the former is not fully statized. But in a racket economy there nevertheless exist intimate proximity of public and private power; oligarchic, market-constricting control over the economy's commanding heights; nearly complete corruption of officialdom responsible for economic policy; and the absence of any semblance of the rule of law in the realm of economic activity.

It is interesting to look at the results of surveys conducted by Russian Centre of Sociological Research in 1998 (see Tables 1, 2, and 3). The Centre asked owners of businesses of different size questions about racket problems.

Table 1. The Diffusion and Importance of 'Racket'

	Cities where surveys were conducted			Average in three cities
	Ul'yanovsk	Smolensk	Moscow	
Number of contacts with racket	41.7	40.7	47.7	43.3

during the last six months				
Contacts on regular basis	56.7	51.9	86.0	62.8
Estimation of the racket problem, on the scale from 1 to 10[10]	3.28	2.47	3.63	3.13
Source: Russian State Statistics Committee (1998), "Obzor Ekonomiki Rossii/Overview of Russia's Economy", p. 169				

Table 2. The Role of Racket

Which roles does racket carry out?	Percentage of those answering "yes"
Protection from crime	82
Ensuring contracts enforcement	33
Intermediary between businesses and state power	13
Source of investments	12
Attracting customers	1
Source: Russian State Statistics Committee (1998), "Obzor Ekonomiki Rossii/Overview of Russia's Economy", p. 170	

Table 3. The Problems of Russians Associated with Owning a Business

Answers to the question "How important are these problems in Russia, on the 1 to 10 scale"	Cities where surveys were conducted			Average in three cities
	Ul'yanovsk	Smolensk	Moscow	
High tax level	8.38	8.00	8.57	8.30
The lack of capital	6.97	6.67	6.57	6.72
High lease and rent cost	6.02	5.58	7.88	6.61
Corruption	6.25	5.42	4.83	5.81
Legal exposure	5.72	5.45	5.66	5.60
Competitors	4.13	4.65	5.56	4.82
Inflation	4.00	5.45	5.36	4.36
Racket	3.28	2.47	3.63	3.13
Source: Russian State Statistics Committee (1998), "Obzor Ekonomiki Rossii/Overview of Russia's Economy", p. 174				

The results shown in the tables above demonstrate that on average, business owners made 7.22 contacts with racket structures in 1998. This high number can be interpreted as showing the great importance of racket in business life. Another interesting finding of the

[10] 1 is least important and 10 is most important

above surveys is that business owners did not consider racket to be a problem of Russian reality – racket only received 3.13 points out of ten. The problem of high tax level was given 8.30 points out of ten, and the problem of corruption received 5.81. The majority of respondents – 82 percent – viewed racket as a structure, which can protect businesses from crime. Another significant answer about the role of racket was to ensure contract enforcement – 33 percent of respondents. These high numbers prove that reliance on legal institutions is minimal – if somebody owes you money or does not adhere to contracts, it is faster, easier, cheaper, and more predictable to appeal to racket than to apply for legal help from the court system.

Yavlinsky (2005) argues that this order of Russian life, when businesses have to ensure all liabilities relying on their own sources, not on the Russian legal system, promoted further development of the oligarchic nature of the post-Soviet economy. According to Yavlinsky (2005), around 70 percent of Russian GDP was controlled by 20-30 business structures. Therefore, the development of a second, shadow system of enforcement, as well as the development of oligarchy, is neither a fortuity nor a peculiarity of the transition period, but rather a consequence of the lack of formal institutions in post-Soviet Russia. Later, when institutions were slowly developing, oligarchy and shadow structures were not in a hurry to give up their power, consequently hindering stable economic development. As Fish (1998, p. 113) notes: "Given the multifaceted foundations and the deep entrenchment of the racket economy, racketization may appear to be irreversible in Russia".

3.3.3. Overall Decline of Russia's Socio-economic Performance

The following table presents the dynamics of some development indicators in post-Soviet Russia.

Table 4. Selected Economic and Social Indicators, 1992-2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Economic indicators											
GDP, PPP-dollar	813.7	742.9	648.5	621.9	600.2	605.0	583.4	620	1120	1200	1200
GDP, billion US $	N/a	N/a	470.5	313.4	384.9	404.9	268.5	194.5	259.5	306.5	345.6
Foreign debt, billion US $	n/a	112.7	119.9	120.4	125.0	123.5	n/a	180.0	162.8	161.4	150.8
Foreign debt servicing, billion US $	n/a	20.7	20.2	20.2	18.7	13.7	10.8	10.6	10.2	n/a	n/a
Foreign Direct Investments, billion US $	n/a	1.2	0.6	2.0	2.5	6.6	3.4	4.3	4.4	3.98	4.0
Consumer Price Inflation, %	1500	634	215.1	131.3	21.8	11.0	84.4	36.5	20.2	18.6	15.1
Federal budget deficit, % of GDP	14.7	n/a	n/a	3.4	4.7	5.4	5.9	0.9	-	-	-
Federal budget surplus, % of GDP	-	n/a	n/a	-	-	-	-	-	1.9	2.9	0.9
Industrial output, 1990=100	75	n/a	n/a	50	n/a	73.3	46	51	57	60	62
People employed in industries, 1995=100	n/a	n/a	n/a	100	93.3	87.5	82.3	81.7	83.1	83.0	80.5
Deterioration of machines and equipment, %	46.8	n/a	n/a	47.9	n/a	n/a	53.6	55.1	51.6	52.3	54.0
Social indicators											
Population, million	148.7	n/a	147.9	147.6	147.1	146.7	146	145.6	n/a	n/a	145.1
Life expectancy at birth (1987=70.13)	67.9	65.1	64.0	64.6	65.9	66.8	67.0	65.9	65.4	65.2	64.9
Birth rate per 1,000 (1985=16.6)	10.7	9.4	9.6	9.3	8.9	8.6	8.8	8.3	8.7	9.1	9.7
Mortality rate per 1,000 (1985=11.3)	12.2	14.5	15.7	15.0	14.2	13.8	13.8	14.7	15.4	15.6	16.2
Unemployment, % of labour force	n/a	5.4	7.4	8.3	9.6	10.8	11.9	12.6	10.5	9.1	8.1
Outstanding balance of unpaid wages as % of gross monthly wage	10	n/a	n/a	66	133	167	152	103	90	n/a	n/a

fund in all national economy											
Gini Coefficient (1991 =0.26; 2004 = 0.4)	0.29	0.4	0.4	0.38	0.38	0.38	0.38	0.4	0.4	0.4	0.4
Population living below country's poverty line, % of all population	33.5	n/a	n/a	24.8	22.1	20.8	23.4	28.4	29.0	27.5	24.5

Sources:
Russian State Statistics Committee Publications:
Demographichesky Ezhegodnik Rossii 2005 (Demographic Yearbook of Russia 2005).
Finansi Rossii 2004 (Finances of Russia 2004);
Kratkosrochnie Ekonomicheskie Pokazateli Rossiskoi Federatsii 2005 (Economic Indicators of Russian Federation 2005);
Naselenie Rossii. Demographicheski ezhegodnik 2005 (Population of Russia. Demographic Yearbook 2005).
Naselenie Rossii za Sto Let, 1998 (Russian Population during 100 Years, 1998);
Obzor Ekonomoki Rossii 1998 (Review of Russian Economy 1998), p. 50, 169;
Obzor Ekonomoki Rossii 1999 (Review of Russian Economy 1999), p. 125;
Obzor Ekonomiki Rossii 2000 (Review of Russian Economy 2000), p. 67;
Rossiiski Statisticheski Ezhegodnik 1996 (Russian Statistics Yearbook 1996);
Rossiiski Statisticheski Ezhegodnik 1997 (Russian Statistics Yearbook 1997), p. 142;
Rossiiski Statisticheski Ezhegodnik 1999 (Russian Statistics Yearbook 1999), p.155;
Rossiiski Statisticheski Ezhegodnik 2002 (Russian Statistics Yearbook 2002), p.187;
Rossiiski Statisticheski Ezhegodnik 2004 (Russian Statistics Yearbook 2004);
Rossiya v Tsifrah 2004 (Russia in Numbers 2004), p. 185;
Rossiya i Strani Mira, 2004 (Russia and the World, 2004), p. 72;
Promishlennost' Rossii, 2005 (Russian Industries, 2005), p. 21, 75;
Problema Neviplati Zarabotnoi Plati na Rossiiskih Predpriyatiyah. Analiticheski Doklad, 2000 (*Problems of Delays in Wage Payments on Russian Enterprises. Analytical Report,* 2000).
www.russtats.ru

As shown in the above table, the majority of socio-economic indicators of Russia's development do not demonstrate positive changes in the country's life. Compared to 1990, the country's industrial output decreased by 38 percent. The social costs of transition have also been very high. Even though the percentage of people living in poverty has been slowly decreasing during the last few years, the level of inequality stays very high. Owing to worsening quality of health care[11], poor quality of life, increased rate of depressions and

[11] In Soviet times, an annual clinical examination was an obligation for every citizen. Every year, workers received paid days off to go get a free examination by all major medical specialists. This, according to Russian Ministry of Health, allowed for the diagnosis of major conditions at their early stages. The slogan of Soviet medicine was "It is easier to prevent the problem than to treat it". After 1991, the annual obligatory clinical examination was abolished. Another aspect of Soviet health care is that it was absolutely free. In modern Russia,

alcoholism[12], the Russian demographic situation is truly disastrous. In 1987, life expectancy at birth was 70 years. In just 15 years, this number decreased to 64.9 years. The death rate has been significantly exceeding the birth rate in Russia during the last 15 years. In his address to the state 2006, President Putin called the country's demographic situation "the most acute problem of modern Russia".[13] Florio (2002) compares the Russian disaster with the situation in post-war European countries. Russian political scientist and sociologist Kagarlitsky goes even further and compares Russian transformation with a nuclear attack:

> According to the experts of the 1960s and 1970s, a limited nuclear conflict would mean the loss of three to five million people, about 40 percent of industry, and more than half of agriculture. After the nuclear strike the country would only recover production after two years. Fortunately, nuclear war did not happen. Instead, in the '90s economic reform took place, 'shock therapy' to be exact. The result of this wonderful experiment on us precisely matched the consequences expected from a medium-scale nuclear attack (quoted in Millar, 2000, p. 329).

Let us now discuss why outcomes of radical reforms in Russia were so different from what their advocates promised.

4. Explanations of the Theory-Practice Divergence – Institutions Matter.

In the last section I demonstrated that the outcomes of shock therapy were not socially desirable. This leaves a number of unanswered questions. These are: why did practice stray so far from what theory promised? What type of macro mistakes were made that led to microeconomic disasters? These questions do not have a single simple answer. But the majority of writers agree with the point of view formulated by Alexander Lukin (1999, quoted in *Wilson Quarterly)*, a political scientist at the Moscow State Institute for Foreign

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it is still free *de jure*. But in reality, in order to get major exams or treatments for free, a person has to wait for a significant amount of time – weeks and sometimes months. Paid services are available immediately but not everybody can afford them.

[12] By 1997, alcohol consumption in Russia significantly increased. The number of deaths from alcohol poisoning sharply increased from 10.8 per 100,000 in 1992 to 37.4 in 1994 (Schwarz et al., 2002, p. 10).

[13] Full text of the speech is available in Russian at www.kremlin.ru.

Affairs: "[The disaster] resulted from a 'ruthless' effort by fanatical democratic ideologues to impose their abstract ideal on a country lacking the necessary cultural preconditions".

For the reformers, a market economy was *a priori* better than a centrally planned model. This proposition is not in question. Evidence shows that developed market economies outperformed central planning by far. The question is, as Murrell (1991) puts it, "can neoclassical economics underpin the reform of centrally planned economies?" In other words, is market reform just a "simple paradigm of free market?" Are markets as simple as textbooks say? This paper argues that reformers' idea about how markets function was oversimplified.

Markets do not function in a vacuum. To create a market economy that would lead to socially desirable outcomes, the system needs a set of institutions, which would "channel and guide self-interested energies into constructive activities" (Tobin, 2001). Otherwise, the "invisible hand" of market regulations leads to the outcomes observed in Russia – phoney capitalism with "[t]he anything-goes-if-you-can-get-away-with-it mentality" (Tobin, 2001, p. 67). This distorted market enriches a limited number of individuals leaving the majority of the population out of its benefits. Tobin (2001) continues that undisciplined self-interest impels businesses to seek and protect monopolistic positions.

To better understand the role and significance of institutional aspects in Russian market reforms, let us first define market institutions and organizations:

> Institutions [are] formal and informal rules and their enforcement mechanisms that shape the behaviour of individuals and organizations in society. By contrast, organizations are entities composed of people who act collectively in pursuit of shared objectives. Thus, organizations and individuals pursue their interests within an institutional structure defined by formal rules (constitutions, laws, regulations, contracts) and informal rules (ethics, trust, religious percepts, and other implicit codes of conduct). (The World Bank, 1998, p. 11).

Stiglitz (2002) points out that Soviet Russia had institutions with the same names as those of capitalist countries but with a very different set of functions. For example, it had banks but they did not have rights or abilities to decide who would get loans as this function was carried out by the state. With the destruction of the state-run economic institutions, Russia did not have anything to replace them with – the country did not have operational codes, capitalist accounting practices, bankruptcy procedures, and commercial banking requirements to guide business decision-makers. The Russian court system was not ready to deal with the realities of a market economy. The country did not have regulations for contract enforcement and property rights protection.

> Much of what we took for granted in our free market system and assumed to be human nature was not nature at all, but culture. The dismantling of the central planning function in an economy does not, as some had supposed, automatically establish a free market entrepreneurial system. There is a vast amount of capitalist culture and infrastructure underpinning market economies that has evolved over generations: laws, conventions, behaviors, and a wide variety of business professions and practices that have no important functions in a central planned economy (Greenspan, 1997, as quoted in Hough, 2001, p. 4).

Consequently, the character of newly created private industrial sector was completely anarchic (Goldman, 2000). Greenspan (1997) notes that it was the biggest mistake of Western advisers and Russian policy makers not to consider this aspect of reforms from the beginning. Privatization measures were applied well ahead of institutional reforms (see Table 5).

Table 5. Privatization and Development of Market Institutions in Russia, 1992-2003[14].

	Institutional changes and development
January 1992	Liberalization of prices
October 1992	The beginning of voucher privatization
July 1994	The beginning of cash privatization
October 1994	*New Civil Code of Russia*
December 1995	*New Law on joint-stock companies regulations*
January 1999	*First part of new Tax Code*
February 1999	*Bankruptcy Law*
February 1999	*Law on protection of investors rights*
June 2001	*The beginning of judicial system reform*
April 2002	*Corporate Governance Code*
Sources: Audit Chamber of Russia (2003); Andreff, W. (2004), "Russian Privatization" (in Russian) in *Voprosi Ekonomiki,* No 6, pp. 79-94.	

Despite the lack of institutions, the new business class had to find ways to survive in the Russian reality. As a result, real market institutions were substituted in Russia by their ersatz. As discussed in chapter 3, companies used barter operations or American dollars instead of Russian currency and used illegal "private" justice instead of state laws. Polterovich (2001) defines the negative outcomes of reforms, connected to underdevelopment of institutions as "institutional traps". The problem associated with institutional traps is that when real institutions start to develop, they are at risk of becoming just a useless decoration within a well-developed practice of non-legitimate relationships (Yavlinsky, 2005).

Arguing for the significance of institutions in a market economy, Olson writes:

[14] As shown in the Table 5, major market institutions were established in Russia much later than such reforms measures as liberalization of prices and privatization took place. For example, the majority of companies became private in 1994-1997 but new tax procedures and regulations as well as bankruptcy procedures had not started till 1999! Judicial system reforms had not begun before 2001! One of the reforms goals was to attract foreign investment, but the Law on the protection of investors' rights was only issued in 1999. The Code on Corporate Governance, very important for proper functioning of companies, was only issued in 2002.

> [R]ational decision making with poor institutions does not lead to optimal outcomes. Those countries with the best policies and institutions achieve most of their potential, while other countries achieve only a tiny fraction of their potential income. The individuals and firms in these societies may display rationality... but this individual achievement does not generate anything remotely resembling a socially efficient outcome... the poorer countries do not have a structure of incentives that brings forth... productive cooperation... and the reason they don't [sic] have it is that such structures do not emerge automatically as a consequence of individual rationality. The structure of incentives depends not only on what economic policies are chosen in each period, but also on the long run or institutional arrangements: on the legal system that enforces contracts and protects property rights and on political structures, constitutional provisions, and the extent of special-interest lobbies and cartels (quoted in Klein, 2006, p. 938).

Institutional and legal infrastructures are required to make an effective market economy. But proper institutions cannot be created overnight. They develop on a gradual basis. Therefore, reforms in Russia should have been conducted on a gradual basis when existing institutions could have been gradually modified to fit the new market economy framework. The outcomes of Russian reforms have proved this theoretical approach to market development. In Russia – a country with a long history of a distorted system of business functioning, monopolies development, and widespread corruption - shock therapy created capitalism of the gangster type, which could not have brought socially desirable outcomes.

4.1. The Distorted System of Business Functioning in Soviet Time and Its Influence Over Reforms.

Applying shock therapy, reformers assumed that Soviet socialist enterprises were not different in principle from capitalist firms. In order to transform Soviet companies into effective market enterprises, the reformers suggested two major measures – abolishing directive planning and creating private ownership over companies. According to one prominent reformer:

> [Y]ou must abolish the government's thoroughgoing, centralized control of the economy. You must eliminate state planning... You must abolish the intricately detailed production orders issued by central planners to enterprise managers... You must abandon absolutely bizarre planned quota system... You must eliminate the State Price Committee... [You must conduct] comprehensive privatization (quoted in Adams and Brock, 1993, pp. 10, 13).

In reality, Soviet enterprises were not independent economic agents. After the end of the New Economic Policy (NEP) in late 1920s, the enterprises in the Soviet economic system could not function independently. They had the role of huge departments in the State planning system. That is, managers of Soviet enterprises were not performing real managers' duties, as this function belonged to a variety of State Committees. As Nove (1989) points out, the main task that business managers had to perform was to carry out plans. In the Soviet reality, independent decisions were not only prohibited but also strictly punished. It is a well-known fact that starting from the end of 1920s, all Soviet factories had so-called *commissars* (later *partorgs*), whose role was to oversee companies' managers in order to avoid any movements—political or economic--unacceptable to "the Party politics".

Analyzing this order of Soviet enterprises, Menshikov (1991), writes that the administrative command system was dominated by voluntarism. Starting from early 1930s, the Soviet Union created a system of centralized People's Commissariats (later ministries) charged with the task of the direct supervision of businesses. These Commissariats and later ministries carried out the role of intermediaries between the businesses and the State Planning Committees. They, not local managers bargained for current and capital resources. This system left no room for managers' initiative and decision-making; managers had simply no need for that. The issues that were viewed as being within managers' autonomy were highly limited. As Nove (1989) states, the role of Soviet managers boiled down to "simple executants of orders" (p. 77). All output in the Soviet Union was classified as "funds" (Menshikov, 1991), or, in other words, the object of non-market distribution. Funds were controlled by central agencies. This meant that all producers and consumers depended on those who controlled funds, and that nothing could be bought or sold without central Committees consent. Enterprises were told what to produce, from where to obtain the inputs, at what price to sell products, and to whom. They had also no power in changing planned wage levels. Nove (1989) concludes that the real role of managers at enterprises was limited to supervising the technical operations – to ensure that machineries are oiled and that all workers perform their tasks.

Therefore, Soviet enterprises were a very specific economic phenomenon, to which the classic theory of capitalist firm could not have applied (Berlinger, 1999). In other words, despite the reformers' expectations, these companies could not have been transformed into effective economic agents of capitalist production in a few months. Privatization, for which reformers had high hopes, was simply a formal change of legal status of enterprises and the abolition of state control. Very often, managers who had no real power over the companies were appointed to become the new owners. For example, following the regional Programme of Privatization, a construction company "Omskagropromstroy - 3" became a joint-stock company over the course of one night. The process of privatization was very "informal" – the company first received a directive from the government of Omsk region regarding dates and the method of privatization. In the same letter, the government assured that "Omskagropromstroy-3" became the assignee for all manufacturing capabilities it had. Following the directive, the management of the company organized a meeting with all workers where the workers were simply notified that they were now working for a joint-stock company. The method of privatization was that the shares were going to the asset management of the directorate, which was now responsible for the company's success and further development. Many Russian companies can tell similar stories about how they became private.

With the destruction of the old Soviet state control institutions, new owners received much more freedom than they ever had before. These new "owners", in contradiction of the reformers' expectations that they would try to improve the companies' performance, considered that they could now strip assets from their companies as they wanted (Goldman, 2000). As Stiglitz (1999) points out, incentives were perverse – why expand energy in creating wealth when it so much easier to steal it? Instead of increasing the value of firms through reinvestment, manager-owners extracted income streams from firms, diverted cash flows to offshore accounts, and delayed payments of dividends to minority shareholders (Hough, 2001). As Oleinik (2004) states, underdeveloped stock markets also contributed to the lack of control over new owners. New companies' owners were not concerned about shareholders. Stiglitz (1999) notes that the road ahead was uncertain and difficult for new owners, and they preferred not to wait for creation of capital markets but rather focused on what they could get out of the company in the next few years.

Privatization destroyed the old mechanisms of administrative control over companies' managers but did not offer new market regulations such as, for example, corporate governance. Companies had to operate in a complete institutional vacuum. There were no mechanisms to ensure that markets operated in a fair manner, that managers did not take advantage of shareholders, and that if an individual stole property, he could be brought to court. With the lack of such institutions, the newly created class of company managers was very good at maximizing profits but only those that went into their own pockets.

4.2. The Monopolistic Nature of Soviet Enterprises.

Another significant aspect of the Soviet economy, which influenced the results of reforms, particularly, the negative results of privatization, was that of monopoly. As the Russian Prime Minister summarized in early 1990s:

> Engels told us that socialism was a single giant factory; Lenin was a devout admirer of...giant, turn-of-the-century capitalist monopolies. He regarded them as superior economic organisms, which would be able to survive better... The wise policy he believed was not to resist concentration of industry but to promote it. Monopoly, for Lenin, was 'building blocks of socialism' (quoted in Adams and Brock, 1993, p. 47).

As a result, during the entire 70-year history of the Soviet Union, the planned economy was fighting so-called parallelism of the functions of production, considering it to be a sign of inefficiency. In the Soviet economy, competition was viewed as a way to waste resources; therefore, in order to avoid waste, all enterprise-building was based on monopoly. All the major industries of the Soviet Union – oil and gas, energy, railways, metal production, chemical production, heavy machinery production – were monopolistic. For example, as Cohen et al. (1998) illustrate, of the ten towns of the Krasnoyarsk *kray*[15], with more than ten thousand inhabitants, six were dominated by one producer, employing more than 40 percent of the township workforce. For many of the inhabitants of these towns, the next possibility for employment was several hundred kilometers away[16]. This situation was similar in the majority of Russian regions. Around 75 percent of Soviet enterprises employed 1,000 and more people (Adams and Brock, 1993, p. 51).

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[15] Region

[16] The next major regional center is around 800 km from Krasnoyarsk.

The monopolistic nature of Soviet industries had a very important implication for reforms--by the time these industries became private, the preconditions for developing competition in a short period of time were not in place. There was no magic wand to create a second manufacturer overnight. In Russia, the reforms' slogan of "liberalization plus privatization" amounted to no more than the liberalization of privatized monopolies. In other words, the state control and voluntarism of the Soviet period was replaced with private arbitrariness. Examples of this arbitrariness could have been found everywhere:

> One day after prices were deregulated, VAZ[17] announced price hikes of 750 percent. Management's rationale was straightforward: 'Ten million people are bidding for the 700,000 cars we produce annually, and among these people, more than enough can afford to pay the higher price… Satisfying demand by increasing production would make buyers less willing to pay higher prices. Our current profit margin is 33 percent per vehicle. Increased production would threaten this profit by chipping away at the price. Lower prices would force us to cut costs which would mean shrinking our labour force of more than 250,000 people. While we still have the opportunity, we choose the easier way. We maintain profits by raising prices rather than reducing costs'" (quoted in Adams and Brock, 1993, p. 53).

Pomer (2001) points out that all enterprises, which were in monopoly positions, favoured price increase over output increases. Most Russians lost nearly all their savings. The monopolistic position of newly-privatized companies also made its effects felt in worsening conditions for employees – companies could not pay workers their overdue wages, and workers could not easily find other employment.

Therefore, as Arrow (2001) argues, Soviet-style monopolies were unsuited to the needs of the market since the "best operation of a market system requires competition to hold prices close to costs and to punish technological backwardness". As Stiglitz and Ellerman (2001) point out, two constituents are important to achieve efficient outcomes of economic

[17] Vaz is Volzhsky Avtozavod (Volga Cars Factory), which produces LADAs.

reforms – privatization and competition. But as they cannot be both implemented simultaneously overnight, the emphasis should be given to the latter, not to the former as happened in Russia. Only the presence of both aspects of a market economy can lead to positive outcomes for reforms.

As Stiglitz (1999) suggests, a major mistake of Russian reformers and their advisors was an assumption that the restructuring of enterprises is impossible before their privatization. Stiglitz (1999) reasonably argues that the experience of Poland proves that restructuring of the economy is possible before privatization is implemented. This point of view is also supported by Arrow (2001), who insists that, before privatization, enterprises should have been divided into viable operating firms. In this case, the firms would form manageable economic units; they should be competitive whenever possible; and they should be capable of privatization if they prove profitable. Arrow (2001) also asserts that change to private ownership is likely to be smoothest in businesses with low capital requirements and where owners participate in day-to-day operations and activities.

Consequently, radical reforms in Russia, particularly, their privatization constituent, had a sequencing problem. Transition to a market economy could and should have started with the creation of a competitive environment, and only after that should large-scale enterprises have been privatized. The Russian case demonstrated that removing the controlling functions of the state makes sense only when basic market mechanisms are already working. Otherwise, formal liberalization means legitimizing monopolies' excess profit, which does not lead to higher standards of economic performance.

4.3. The Corrupted Nature of Russian Society and Its Influence Over the Reforms.

Ryvkina (1991) argues that economic development cannot be fully understood without studying its connection with the cultural life of society. How did the cultural aspects of Soviet Russia influence the results of market reforms? And how did the lack of proper institutions intensify this influence?

A wide variety of informal rules of social and economic behaviour developed in Russia over many years, and was not easy to break up overnight. These rules and behaviours – widespread social networks and connections, bribery and corruption – had a significant role under the Soviet system, and are the characteristics of modern Russian reality as well (Ledeneva, 1998).

4.3.1. Historical Background of the Development of Corruption Under the Soviet Regime.

According to Easter (1996), the culture of using networks and connections in order to achieve personal goals is rooted in the beginning of the Bolshevik state. To develop survival strategies in tsarist Russia, the Bolsheviks had developed underground ties and informal relationships between themselves. After the Bolshevik party succeeded in its political struggle, it was time to use the established networks in a different fashion (Easter, 1996).

Empowered to appoint personnel, manage finances, and allocate goods, regional party leaders strengthened personal ties, as they became a means of access to scarce and valued resources. This was the time when corruption began to emerge in Soviet Russia (Easter, 1996).

Later, when the Soviet state became a repressive structure, the importance of personal interconnections was to grow as a response to the state's policies (Gibson, 2001). The development of networks was to some extent a substitute for formal public organizations. Therefore, a well-known phenomenon of Russian corruption and wide usage of personal networks does not only due to the historical circumstances in which the Bolshevik state had developed, but also to other peculiarities of Soviet realities. As Clark (1993) observes, some Soviet-specific influences contributed to the development of networks closely associated with corruption as it is defined as "… the perversion of an official's public duties for personal gain" (p. 3). In particular, Clark (1993) suggests that the economic nature of the Soviet Union related to the development of corruption.

One economic aspect of the Soviet state is considered by many (e.g., Clark, 2003; Ledeneva, 1998; & Verdery, 1996) to be the most important for the development of corruption. The economy as operated by the Plan created severe scarcity, and only those who had connections would have access to goods and services. Consequently, in socialism, the clerk, or seller, did not have to be friendly to the buyers or customers, but, on the contrary, the customers had to "ingratiate themselves with smiles, bribes, or favors" in order to obtain goods or services (Verdery, 1996, p.22). Verdery (1996) illustrates her points by making an interesting analogy between the lemonade factory and its customers in capitalism and the communist party ("a factory") and population ("thirsty customers") in socialism. She states that in socialism, the point was not profit, but the relationship between "thirsty persons" and the one with the lemonade – the Party center. Bribes and favours in order to obtain goods and services could be called everyday corruption, whereas engagement in illegal trades and taking bribes for allowing those illegal trades could be called a form of official corruption. Clark (1993) summarizes:

> Soviet officials were, by virtue of their strategic positions in the running of the Soviet economy, placed in a day-to-day situation marked by the increased opportunity for personal and institutional aggrandizement... In... heavily administered economy [of the Soviet Union] marked by a sizeable monetary overhang and severe chronic scarcity, the corruption of its officials was almost inevitable (p. 74).

Even though the Soviet state attempted to fight corruption with harsh penalties and even death penalties for the most severe incidents, it was not able to prevent the many and various forms of illegal procurements (Hammer, 1990). According to Faust et al. (2002) personal networks, client-patron relationship, and coalition building were rather common for Soviet society due to the fact that, unlike in Western democracies, the members of the upper echelons of the Communist party (e.g. the Politburo and the Secretariat) were not voted into office by the public but were admitted by agreement of standing members.

The use of personal networks among ordinary Soviet citizens became an absolute norm and a regular practice in Soviet times as well. Russian proverbs "[d]o not have 100 roubles, but do have 100 friends" (*Ne imei sto rublei, a imei sto druzei*) and "I scratch your back, you scratch mine" (*Ty –mne, ya -tebe*) illustrate this trend of Soviet society very well. Ledeneva (1998) asserts that personal networks were used for different needs in different historical periods of Soviet Russia but one aspect was always constant – networks were always related to the distribution of material welfare.

4.3.2. Corruption and Market Reforms.

The picture of Russia as it faced a new era of transition to a market economy was of a country with an ideology and mentality influenced by a highly corrupted political system and a rather handicapped economy. Lane and Ross (1999) sum up that under state socialism in Russia, the political and economic elite were contained within the state apparatus, and a major distinction from capitalism was the absence of private capital.As suggested by many (e.g. Freeland, 2000; Klebnikov, 2000; Lane and Ross, 1999; Ledeneva, 1998; & Shiraev, 1999;) the Soviet political elite simply transformed itself into the economic elite of the new Russia, maintaining absolute power – both political and financial.

The role of connections during large-scale privatization was significant. Freeland (2000) compares the post-Soviet years in Russia with the idea of revolutions. She notes that the simplified idea of all revolutions is to expropriate the loot from the opponents and to distribute it among the friends. Following this comparison, one can observe that the *nomenklatura* and Red Directors were the majority of those who received the loot, as they formed most of the businesses in the second wave of reforms during the Yel'tsin era (Lane and Ross, 1999). This was the time when many of Russia's well-known oligarchs had their start.

Freeland (2000) points out that during the time of privatization the political elite's intention was not to let newly privatized companies pass into the hands of new young businessmen who arose during the first stage of developing markets in post-Soviet Russia. Instead, priority was given to the old industrial bosses known as Red Directors as well as to the Communist Party *apparatchiki*. For example, officially, voucher privatization pursued the idea of giving all workers equal opportunities to become share-owning capitalists in every privatized company. But the Russian political elite lobbied President Yel'tsin to restrict the employee-owners numbers on board of directors to, at most, one-third, even if workers had a majority of share ownership (Ellerman, 2003). As discussed earlier in this paper, real power in privatized companies was concentrated in the hands of the former top managers, or Red Directors, now the *de facto* owners. If managers of privatizing companies wanted to grab even more of their companies than they were granted according to the programmes of Privatization, the officials were “inclined to turn a blind eye”.[18]

For example, the Audit Chamber (2003, p. 50-53) states that during cash privatization, the executive power of Russia “ignored” many illegal acts regarding privatization. This led to the situation when strategically important objects were privatized. For instance, the government of Russia legitimized privatization of major coal-mining companies “Kuzbassrazreaugol” and “Yuzhny Kuzbass”, which were in federal ownership and could not have been privatized according to the Federal Law # 123-FZ. Among other strategically important companies, which were privatized contrary to the State laws, were the Moscow heavy machinery factory “Znamya”, the Taganrog aircraft factory, the Tula arms factory, the Voronezh enterprise “Electropribor”, and the Tula Research Institute for Control Systems. As the Audit Chamber (2003) suggests, this is not a full list of illegally privatized companies. A significant portion of companies were sold at false auctions and for prices lower than the companies’ real value. For example, the production facilities of “Omskagropromstroy-3” were sold at the auction for ten percent of their real value. The Audit Chamber (2003) lists a variety of companies sold for low prices. Another example is a highly profitable oil company “Tyumenskaya Neftyanaya Kompaniya”, the selling price of which was lower than its real value by 920 million USD. The Audit Chamber (2003) had only audited ten companies privatized by auction – and in all ten of them the selling price was significantly lower than the real value! Figure 1 shows the dynamics of illegal actions in the privatization sphere during 1995-2002.

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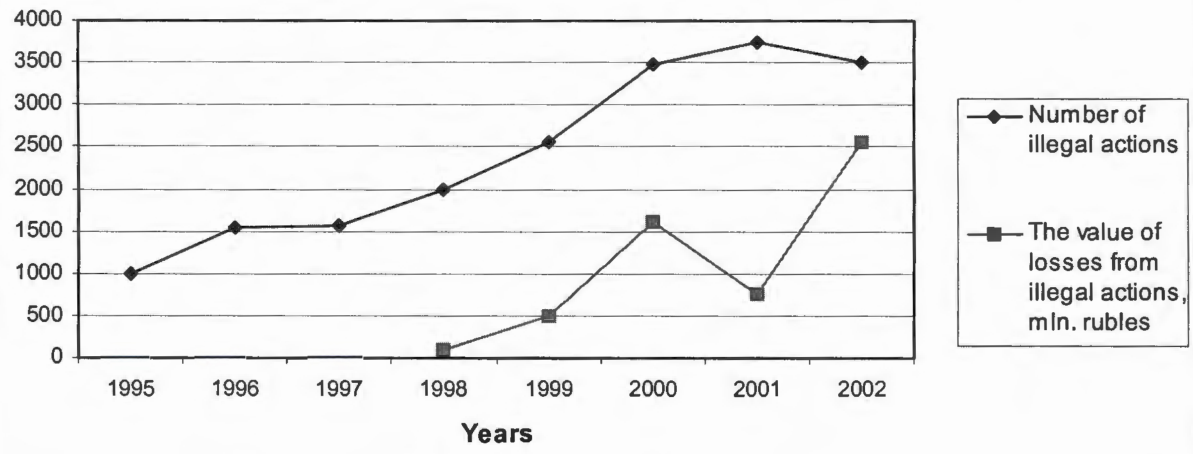
[18] The word “privatizatsiya (privatization)” is commonly used by Russians as “prikhvatizatsiya (grabification)”.

Figure 1. Illegal Actions in the Sphere of Privatization, 1995-2002



Source: Audit Chamber of Russia (2003), *Analiz Prtsessov Privatizatstii Gosudarstvennoj Sobstvennosti Rossiiskoi Federatsii za Period 1993-2003 Godov (Analyses of Privatzation of State Property in Russia in 1993-2003),* p. 66.

As discussed in the beginning of this paper, one of the goals of shock therapy was to "blow up the Soviet economy". That is why Mikhail Berger, a Russian journalist who chronicled the privatization programme, summarized Russian privatization in a slogan "Corruption for the sake of Democracy" (quoted in Freeland, 2000, p. 67).

Shiraev (1999) argues that the new economic elite have been more criminal and corrupted than the old Russian elite ever was. Close connections between businesses and the state in Russia only intensified the corruption. In the mid-1990s, the Duma issued a number of laws which increased their privileges and provided them with immunity against any crime. Moreover, many government officials had owned stocks in different companies, and developed informal relationships with companies' top-managers. The principle of reciprocity that was so common in Soviet times can also be found in these informal relationships. Bureaucrats offered business elite groups a variety of privileges such as tax breaks, low-interest credits, export and import protection, and different discounts. In turn, business groups offered politicians funds for this election.

According to Kauffman and Siegelbaum (1997), corruption in the new Russia was intensified by the communist regime's philosophical insistence that "... capitalism and free market were lawless and corrupt at their core" (p.424). Segodina (1995) states that corruption in post-Soviet Russia expanded to such an extent that it threatened "... to take control of Russia's economy and limit access to it by people who are not in the network" (cited in Shiraev, 1999, p.112). Although some scholars, according to Silverman and Yanowitch (2000), argue that the role of the nomenklatura in the new business elite is exaggerated, they nevertheless, admit that "...the development of powerful financial and industrial empires [in Russia] is impossible unless close relationship are formed with the state" (p. 126). Therefore, even if the structure of the economy and political system in Russia has changed, the new business elite accommodated their old ethics and practices within the new society.

The above discussion shows that, given the reality of the lack of laws and regulations, rapid privatization is not able to break the circle of corruption cultivated and polished in Russian society during so many decades. Stiglitz (1999) reminds us that in advanced industrial countries, the rule of law keeps local and state governments from abusing their potential powers. Russia did not have such laws when reforms started. This further corrupted the nature of the Russian Federation and favoured the rise of a variety of illegal activities. As already discussed, many privatization measures were not legitimate. This fact made it imperative that the new oligarchs take their funds quickly out of the country in order to avoid possible further expropriation.

5. Conclusion.

What lessons should Russia learn from its bitter experience with economic and social reforms? As this paper has explored, radical economic reforms based on rapid liberalization and privatization, did not bring promised economic growth and increased quality of life in Russia. Instead, they moved the country into a decade of turbulence, social and economic decline, and overall instability. The Russian experience has proved that markets are not as simple as the classic textbooks of economics would have it. Markets do not function in a vacuum but require a history of institutional development. As Hough (2001, p. 234-235) notes:

> The foremost problem for understanding of Russia... is that we all take for granted a modern society – what Max Weber called a 'rational-technical society'. We take for granted that laws exist and have meaning, that bureaucracies function more or less effectively, and that government and bureaucracy should be damned for being too impersonal rather than the opposite. Adam Smith's phrase 'invisible hand' does not mean anarchy (the absence of a hand), but predictable, impersonal rules, laws, and incentives with a powerful impact on economic actors, but without continual arbitrary and personal intervention by government officials. These must be created.

An important conclusion arises here – a gradualist approach to reforms based on a country's history is essential in designing a reform strategy. Stiglitz (1999) remarks that sequencing and pacing were what the Russian strategy lacked. "Ten years later, the wisdom of the gradualist approach is at last being recognized: the tortoises have overtaken the hares" (Stiglitz, 2002, p. 141).

What are the implications for the Russia's future? The country should continue the development and improvement of important institutional aspects, such as property rights, transparency of the processes of privatization, a proper justice system, a market-based financial sector, effective corporate governance, and further de-monopolization. It is unlikely that the process will be fast and non-problematic. "[I]t is clear that the transition to a market economy will be a long struggle, and many, if not most, of the issues that seemed settled only a few years ago will need to be revisited" (Stiglitz, 2002, p. 135). But one may hope that Russia has learned from its mistakes and that the country is on the right path now to benefit from the reforms.

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